DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 02-0087
Adjusted Gross Income Tax
For Tax Years 1998 through 1999

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ISSUE

I. Adjusted Gross Income—Nexus

Authority: Quill Corporation v. North Dakota, 504 U.S. 298 (U.S. 1992); in Miles, Inc. v. Indiana Department of State Revenue, 659 N.E.2d 1158, 1164 (Ind. Tax 1995); Chief Industries, Inc. v. Indiana Department of State Revenue, 792 N.E.2d 972 (Ind. Tax 2000); Subaru-Isuzu Automotive, Inc., Company v. Indiana Department of State Revenue, 782 N.E.2d 1071 (Ind. Tax 2003); IC 6-3-2-2; IC 6-3-4-14; IC 6-8.1-3-3; 45 IAC 3.1-1-50; 45 IAC 3.1-1-55; 45 IAC 15-3-2; Geoffry, Inc. v. South Carolina Tax Commission, 437 S.E. 2d 13 (S.C. 1993)

Taxpayer protests the imposition of adjusted gross income tax on activity it believes has no nexus with Indiana.

II. Tax Administration—Negligence Penalty and Interest

Authority: IC 6-8.1-10-1; IC 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests imposition of a ten percent (10%) negligence penalty and interest.

STATEMENT OF FACTS

Taxpayer is a member of a consolidated group which operates several chains of retail clothing stores in multiple states and affiliated companies which hold the rights to trademarks and trade brands associated with each particular retail chain. For example, a retail chain named "Retail Clothing Store" would have an affiliated company with a similar name such as "Retail Clothing Store Holdings" which held the rights to the trademarks and trade brand of "Retail Clothing Store". The retailer would pay the affiliated company royalties for the use of the trademarks and trade brands. Also, the affiliated company made loans to the retail company, upon which the retail company paid interest to the trademark holding company. All of these companies are listed together on the Federal consolidated returns, while only the retail stores are listed on the Indiana consolidated returns. As the result of an audit conducted for the tax years at issue, the Indiana Department of Revenue ("Department") issued proposed assessments for additional adjusted gross income tax on the income the trademark holding companies received in the form of royalty payments and interest payments. Taxpayer protests these proposed assessments on the grounds that it has insufficient nexus with the state for Indiana to tax the activities at issue. Further facts will be supplied as necessary.

I. <u>Adjusted Gross Income</u>—Nexus

<u>DISCUSSION</u>

Taxpayer is a member of a group which consists of several related chains of retail clothing stores and affiliated companies which file a consolidated Indiana adjusted gross income tax return. Taxpayer paid royalty income from a retail company to another affiliated company, which the audit refers to as a "royalty-receiving company" (hereinafter "RRC") and which taxpayer refers to in its protest as a "Trademark Protection Company", for the use of trademarks and tradenames owned by the RRC. The retail company also paid interest to the RRC on loans from the RRC. The audit report notes that the RRCs in the group had no payroll or employees and that the tangible property such as is used to compute the property factor of the apportionment computation was so small as to be negligible. Also, the RRCs in the group each had total depreciable assets everywhere of less than ten thousand dollars ($10,000).

The Department conducted an audit for the tax years at issue and determined that the royalty income paid to the RRC and interest paid to the RRC on loans made by the RRC to the retail company should have been included in the consolidated return. Accordingly, the Department issued proposed assessments for adjusted gross income tax on the newly included income. Taxpayer protests that the income should not be included and that the proposed assessments are incorrect.

Taxpayer presents several arguments supporting its position. Taxpayer's first argument is that the amounts of taxes assessed and the methods used to compute such amounts are unexplained by and inconsistent with the audit report, are based on an overstatement of corporate income tax liability for the period at issue, and fail to allow taxpayer appropriate credit for corporate income tax paid for the period at issue. Taxpayer refers to IC 6-3-4-14(a), which provides in part:

> An affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by IC 6-3.

Next, taxpayer refers to IC 6-3-4-14(b), which states:

> For purposes of this section the term "affiliated group" shall mean an "affiliated group" as defined in Section 1504 of the Internal Revenue Code with the exception that the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana.

Taxpayer does not believe that the RRCs should be included in a consolidated return due to the provision of IC 6-3-4-14(b) excluding corporations which do not have adjusted gross income derived from sources within the state of Indiana.

In support of its position that the RRCs do not have adjusted gross income derived from sources within the state of Indiana, taxpayer refers to IC 6-3-2-2(a), which states in part:

> With regard to corporations and nonresident persons, "adjusted gross income derived from sources within the state of Indiana", for the purposes of this article, shall mean and include:
>
> (1) income from real or tangible personal property located in this state;
> (2) income from doing business in this state;
> (3) income from a trade or profession conducted in this state;
> (4) compensation for labor or services rendered within this state; and
> (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.
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> …

Taxpayer believes that the modifier,"…if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter" applies to all income sources listed in IC 6-3-2-2(a)(5). Since IC 6-3-2-2.2 deals primarily with interest income and income from loans, and does not mention income from trademarks or trade brands, taxpayer does not believe that the income received by the royalty receiving corporations for trademark and trade brand use qualifies as adjusted gross income derived from sources within the state of Indiana.

In its protest, taxpayer refers to the Indiana Tax Court case, Chief Industries, Inc. v. Indiana Department of State Revenue (which was issued in 2000 and ruled "For Publication" in 2004) for support in its assertion that the Department's regulations are out of date, but Chief also provides guidance in determining if the modifier found in IC 6-3-2-2(a)(5) applies to all categories listed therein. Chief Industries, Inc. v. Indiana Department of State Revenue, 792 N.E.2d 972 (Ind. Tax 2000). In that case, the Tax Court examined IC 6-3-2-2(a)(5) as it was written in 1986, which was the time Chief Industries stock sales took place. At that time, the modifier in IC 6-3-2-2(a)(5) read, "…and other intangible personal property having a situs in this state." The Tax Court explained that modifiers in the first four subsections clearly modify each item referenced within each subsection, and added:

> To be consistent throughout section 6-3-2-2, the pattern must be read to extend to subsection (5). It would be absurd to read subsection (5) differently than the immediately preceding four subsections.

Id., at 977.

However, as the Tax Court explained in footnote 10 of Chief Industries:

> The current version of section 6-3-2-2(a)(5) omits the phrase "having a situs in this state" and replaces it with "if the receipt from the intangible is attributable under section 2.2 of this chapter. *INDIANA CODE ANN. §6-3-2-2.2* (West 2000), effective January 1, 1990, discusses when income from, among other things, certain loans, sales contracts and dividends is attributable to Indiana.

Id., at 976.

The Tax Court decided that the pre-January 1, 1990 version of IC 6-3-2-2(a)(5) required all items listed therein to have a situs in Indiana, and proceeded to provide a three-part test to determine whether income is derived from an Indiana source or tax situs.

With the language change in the modifier of IC 6-3-2-2(a)(5) came a significant change in the effect the modifier had on the subsection. IC 6-3-2-2.2 contains no reference to eleven (11) of the twelve (12) categories listed in IC 6-3-2-2(a)(5). If all twelve categories were subject to the modification of being attributable to Indiana under IC 6-3-2-2.2, which only discusses one of the twelve categories, it would render eleven of the twelve items not applicable to Indiana under any circumstances.

As the Indiana Tax Court explained in Miles, Inc. v. Indiana Department of State Revenue, 659 N.E.2d 1158, 1164 (Ind. Tax 1995), "The Court cannot presume the legislature intended to enact a nullity." To read the reference to IC 6-3-2-2.2 as modifying all twelve items in IC 6-3-2-2(a)(5) would render the eleven excluded items nullified. Also, more direct evidence that the legislature did not intend to nullify the eleven items in IC 6-3-2-2(a)(5) is the fact that the modification to the subsection was enacted by P.L.347-1989(ss), Sec. 6, while IC 6-3-2-2.2 was enacted by P.L.347-1989(ss), Sec. 7. If the legislature intended to eliminate the eleven items in question from taxation under IC 6-3-2-2(a)(5), it could have simply modified the subsection to incorporate the language of IC 6-3-2-2.2 rather than go to the effort of leaving eleven meaningless categories and creating an entire separate statute to describe the sole remaining relevant category. That the legislature did not do this indicates that it did not intend to nullify the eleven categories, including trademarks and tradenames.

Therefore, since IC 6-3-2-2(a)(5) was altered to include the eleven categories not related to IC 6-3-2-2.2 in 1990, and since the eleven categories can not be presumed to be nullified by the language of IC 6-3-2-2.2, the decisions in Chief Industries and in Miles leads to the conclusion that taxpayer's reliance on the descriptive language in IC 6-3-2-2.2 is misplaced. The legislature altered IC 6-3-2-2(a)(5) so that the modifier can not be logically applied to all twelve categories listed therein. The Chief Industries decision that the entire subsection is modified can only be applied to the pre-January 1, 1990 version of IC 6-3-2-2(a)(5), and taxpayer's belief that IC 6-3-2-2.2 must be satisfied for the eleven non-related categories is incorrect.

In the course of its argument, taxpayer refers to two Revenue Rulings in support of its argument. These two Revenue Rulings deal with Financial Institutions Tax (FIT). Since this protest deals with Adjusted Gross Income tax, and these Revenue Rulings are based on FIT statutes, they are not relevant to this protest and will receive no further discussion.

Taxpayer's next argument that the proposed assessments are invalid is that taxpayer believes that the Department relied on invalid regulations in its audit report. In the audit report the Department referred to several regulations to support its position. 45 IAC 3.1-1-50, in describing sales to be included in the sales factor of the apportionment formula, states in relevant part:

> Sales Made in General Business Operations. "Sales" means all gross receipts of the taxpayer which are not subject to allocation as nonbusiness income. The following are examples of "sales" in various situations:
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> …
>
> (5) If the taxpayer is in the business of selling, assigning, or licensing of intangible personal property such as patents and copyrights, "sales" includes the gross receipts therefrom.
>
> …

Also, the Department referred to 45 IAC 3.1-1-55, which states in relevant part:

> When Sales Other Than Sales of Tangible Personal Property Are in This State. Gross receipts from transactions other than sales of tangible personal property shall be included in the numerator of the sales factor if the income-producing activity which gave rise to the receipts is performed wholly within this state. Except as provided below if the income producing activity is performed within and without this state such receipts are attributed to this state if the greater portion of the income producing activity is performed here, based on costs of performance.
>
> The term "income producing activity" means the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit. Such activity does not include activities performed on behalf of the taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, "income producing activity" includes but is not limited to the following: (1) The rendering of personal services by employees or the utilization of tangible and intangible personal property by the taxpayer in performing a service. (2) The sale, rental, leasing, or licensing the use of other use of tangible personal property. (3) The sale, licensing the use of or other use of intangible personal property.
>
> Income producing activity is deemed performed at the situs of real, tangible and intangible personal property or the place where personal services are rendered. The situs of real and tangible personal property is at its physical location. The situs of intangible personal property is the commercial domicile of the taxpayer (i.e., the principal place from which trade or business of the taxpayer is directed or managed), unless the property has acquired a "business situs" elsewhere. "Business situs" is the place at which intangible personal property is employed as capital; or the place where the property is located if possession and control of the

> property is localized in connection with a trade or business so that the substantial use or value attaches to the property….

Taxpayer believes that since these regulations were promulgated in 1979, prior to the changes to IC 6-3-2-2 which became effective on January 1, 1990, these regulations are invalid. Taxpayer states that since the regulations use the phrase "business situs" they are no longer applicable to determining adjusted gross income tax derived from intangible personal property. The Indiana Tax Court has addressed the impact a change in the underlying statute will have on a regulation. In Subaru-Isuzu Automotive, the legislature had repealed a two-sentence provision dealing with apportionment of Net Operating Losses and replaced it with a lengthy and complex four-step process for calculating Net Operating Losses. Subaru-Isuzu Automotive, Inc., Company v. Indiana Department of State Revenue, 782 N.E.2d 1071 (Ind. Tax 2003). The Department did not promulgate a new regulation in accordance with the new four-step process, and the Court explained:

> An administrative rule is a nullity where the provision upon which the rule is based has been repealed.
>
> Id., at 1076

The Court decided that the regulations relied upon by the Department no longer adequately reflected apportionment process they were designed to enhance, and therefore were no longer valid. Taxpayer's position in the instant case is that the administrative rules (regulations) referred to in the audit report are invalid under the same reasoning used by the Tax Court to describe a nullity in Subaru-Isuzu Automotive.

There is a fundamental difference between a nullified regulation, as described in Subaru-Isuzu Automotive, and the instant case. In Subaru-Isuzu Automotive, the underlying statute had been repealed and wholly replaced while the related regulation did not reflect this change. Here, the underlying statute has merely been simplified, with more complex analysis of one of twelve categories listed being relegated to a separate statute, while the regulation remains applicable to the remaining, unaffected eleven categories in IC 6-3-2-2(a)(5). The underlying statute was not repealed, but rather was modified, and the regulations are therefore not nullities as explained in Subaru-Isuzu Automotive.

Taxpayer's next argument is that the Department erroneously relied on the authority of a South Carolina case, Geoffry, Inc. v. South Carolina Tax Commission, 437 S.E. 2d 13 (S.C. 1993), for its assessments. Taxpayer states that the decision in Geoffrey does not address Indiana adjusted gross income tax, which is of relevance here, but instead addresses Federal constitutional issues. Taxpayer also states that the court in Geoffrey made the wrong decision in that case, and offers a New Jersey case in its place.

A review of the audit report reveals that the Department did not rely on the authority of Geoffrey to reach its assessments. Rather, the Department relied on the regulations previously discussed, and merely used Geoffrey as an example of how a court decided that state taxation of royalty income to a non-resident business was not prohibited by the Due Process Clause or Commerce

Clause of the United States Constitution. In any event, a case decided in another state's courts has no authority in Indiana, which means that both South Carolina's Geoffrey and New Jersey's case are useful only for example purposes, do not form the basis of the assessments, and will not be discussed further.

Taxpayer's next argument is that the Due Process Clause and Commerce Clause of the United States Constitution both bar Indiana from taxing the royalty income. Taxpayer refers to Quill Corporation v. North Dakota, 504 U.S. 298 (U.S. 1992), to support its contention that physical presence is required for a state to impose tax. Quill deals with sales tax, as the Court explains when it discusses the Commerce Clause requirements, "In sum, although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar, bright-line, physical presence requirement, our reasoning in those cases does not compel that we now reject the rule in *Bellas Hess* established in the area of sales and use taxes." Id., at 317. Also, in its discussion of the Due Process Clause, the Court explains that physical presence is not required for a state to impose sales tax. Id., at 308. Therefore, since the instant case deals with income tax rather than sales and use taxes, and the Court specifically states that the physical presence requirement has not been adopted for taxes other than sales and use, Quill provides no support for taxpayer.

Taxpayer's next argument is that the Department changed its interpretation of a listed tax without properly promulgating new regulations. Taxpayer refers to IC 6-8.1-3-3(b), which states:

> No change in the department's interpretation of a listed tax may take effect before the date the change is:
>
> (1) adopted in a rule under this section; or
> (2) published in the Indiana Register under IC 4-22-7-7(a)(5), if IC 4-22-2 does not require the interpretation to be adopted as a rule;
>
> if the change would increase a taxpayer's liability for a listed tax.

Taxpayer also refers to 45 IAC 15-3-2(d)(3), which states:

> In respect to rulings issued by the department, based on a particular fact situation which may affect the tax liability of the taxpayer, only the taxpayer to whom the ruling was issued is entitled to rely on it. Since the department publicizes summaries of rulings which it makes, other taxpayers with substantially identical factual situations may rely on the publicized rulings for informational purposes in preparing returns and making tax decisions. Generally, department publications may be relied on by any taxpayer if their fact situation does not vary substantially from those facts upon which the department based its publication. If a taxpayer relies on a publicized ruling and the department discovers, upon examination, that the fact situation of the particular taxpayer is different in any material respect from that situation on which the original ruling was issued, the ruling will afford the taxpayer no protection and the examination will apply to all open years under the statutes. Letters of findings that are issued by the department, as a result of

> protested assessments, are to be considered rulings of the department as applied to the particular facts protested.

Taxpayer believes that the Department is changing its interpretation in the instant case from its interpretation found in two revenue rulings issued in April, 1982. The text of a summary of one of the rulings states in its entirety:

> Advice was requested as to the taxability of an Indiana-based corporation engaged in receiving copyright royalties from various sources worldwide. All of the property and employees are located in Indiana.
>
> The Department ruled that the taxpayer was subject to gross income tax on its entire gross receipts. IC 6-2.1-1-2(e)(6) provides an exclusion for amounts received at an out-of-state business situs, but this taxpayer has no such situs. Likewise, its entire adjusted gross income is taxable in Indiana because no other state has jurisdiction to impose a net income tax.

Taxpayer states that the rulings could not be clearer or more on point, and that their interpretation of the tax statutes can not be changed prior to the promulgation of a rule or publication in the Indiana Register as required under IC 6-8.1-3-3. Taxpayer states that the audit report's attempt to do so is plainly impermissible under IC 6-8.1-3-3 and would violate taxpayer's rights under 45 IAC 15-3-2 to rely on rulings issued to other taxpayers. Taxpayer is incorrect.

The summary taxpayer refers to is a short summary and provides little information. One obvious difference is that the summary discusses a taxpayer with no activities outside Indiana, while the instant case deals with taxpayers who have activities in several states. Taxpayer emphasizes the last sentence of the summary, which mentions adjusted gross income and is also the tax at issue in this protest. In the summary, the Department explained that the taxpayer's entire royalty income was taxable in Indiana since there was no other taxing jurisdiction to apportion the income with. In the instant case, the Department has apportioned the royalty income according to the apportionment formula explained in IC 6-3-2-2. In other words, there was no reason to apportion in the 1982 instance and there is a reason to apportion in this instance. Taxpayer fails to explain why the last sentence of the summary means that the instant audit represents an attempt to change the Department's interpretation of adjusted gross income tax statutes in this case.

In its protest, taxpayer cites only the first two sentences of 45 IAC 15-3-2(d)(3). It is clear that the two situations are materially different from one another, and as explained in the fourth sentence of 45 IAC 15-3-2(d)(3), "If a taxpayer relies on a publicized ruling and the department discovers, upon examination, that the fact situation of the particular taxpayer is different in any material respect from that situation on which the original ruling was issued, the ruling will afford the taxpayer no protection and the examination will apply to all open years under the statutes." The fact situation of this particular taxpayer is different in at least one material respect from the situation on which the original ruling was issued. Therefore, the 1982 rulings afford no protection to taxpayer.

Next, taxpayer argues that the Department erred in its calculation of the apportionment factors it used to determine the proposed assessments. Taxpayer refers to 45 IAC 3.1-1-55(e), which states:

> Gross receipts from intangible personal property shall, if classified as business income, be attributed to this state based upon the ratio which the total property and payroll factors in this state bears to the total of the property and payroll factors everywhere for the tax period as determined in Regulations 6-3-2-2(c)(010) *[45 IAC 3.1-1-40]* et seq. and 6-3-2-2(d)(010) *[45 IAC 3.1-1-47]* et seq.

Taxpayer states that the audit report does not attribute the royalty-receiving corporation's intangible income to Indiana based on their Indiana property and payroll factors, but rather by multiplying the royalty-receiving corporation's total royalty and interest income by the sales factor of the retailers to whom the royalty-receiving corporations licensed intangibles or lent money. Taxpayer believes that to do so is not only unsupportable under the Adjusted Gross Income act, but is contrary to the regulations. Taxpayer's interpretation of 45 IAC 3.1-1-55(e) is that with zero tangible personal property and zero payroll in Indiana, the apportionment factor should be zero. Taxpayer is incorrect.

The Department refers to IC 6-3-2-2(l), which states:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (1) separate accounting;
> (2) the exclusion of any one (1) or more of the factors;
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

In this case, taxpayer is correct that the royalty-receiving corporations have no Indiana payroll or real or tangible personal property. As previously explained, they do not have payroll or real or tangible personal property anywhere else either. Yet they clearly have income, and if the Department were to follow taxpayer's suggestion that the apportionment be calculated at zero, the result would not fairly represent taxpayer's income derived from sources within the state of Indiana. This situation is resolved by IC 6-3-2-2(l) which allows the exclusion of one or more of the three factors and the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. The Department included the total receipts of the royalty-receiving corporations in the denominator of the sales apportionment factor. The Department multiplied the total receipts for the royalty-receiving corporations by the sales factors of the related retail corporation since royalty revenues are directly based on sales revenues. As explained in the audit report, this results in an accurate and equitable Indiana sales factor numerator.

Taxpayer's next argument deals with the interest payments made by the retailer to the RRC. The Department referred to 45 IAC 3.1-1-59, which explains when interest is treated as business or nonbusiness income, while describing the adjustments in the audit report. Taxpayer states that it is irrelevant if the interest is business or nonbusiness income and refers to IC 6-3-2-2.2 to raise the point that the type of interest income in question is not included in the various descriptions therein and concludes that the interest payment income is therefore not to be included in Indiana income. IC 6-3-2-2.2 states:

> (a) Interest income and other receipts from assets in the nature of loans or installment contracts that are primarily secured by or deal with real or tangible personal property are attributable to this state if the security or sale property is located in Indiana.
> (b) Interest income and other receipts from consumer loans not secured by real or tangible personal property are attributable to this state if the loan in made to a resident of Indiana, whether at a place of business, by a traveling loan officer, by mail, by telephone, or by other electronic means.
> (c) Interest income and other receipts from commercial loans and installment obligations not secured by real or tangible personal property are attributable to this state if the proceeds of the loan are to be applied in Indiana. If it cannot be determined where the funds are to be applied, the income and receipts are attributable to the state in which the business applied for the loan. As used in this section, "applied for" means the initial inquiry (including customer assistance in preparing the loan application) or submission of a completed loan application, whichever occurs first.
> (d) Interest income, merchant discount, and other receipts including service charges from financial institution credit card and travel and entertainment credit card receivables and credit card holders' fees are attributable to the state to which the card charges and fees are regularly billed.
> (e) Receipts from the performance of fiduciary and other services are attributable to the state in which the benefits of the services are consumed. If the benefits are consumed in more than one (1) state, the receipts from those benefits are attributable to this state on a pro rata basis according to the portion of the benefits consumed in Indiana.
> (f) Receipts from the issuance of traveler's checks, money orders, or United States savings bonds are attributable to the state in which the traveler's checks, money orders, or bonds are purchased.
> (g) Receipts in the form of dividends from investments are attributable to this state if the taxpayer's commercial domicile is in Indiana.

Taxpayer states that it is not possible to determine where the proceeds of the loan were applied, therefore IC 6-3-2-2.2(c) requires the income and receipts to be attributed to the state where the loan was applied for. Since the loan was applied for wholly outside of Indiana, taxpayer believes that the income and receipts can not be attributed to Indiana. Taxpayer also reiterates its argument that the regulation relied upon by the Department is invalid due to new statutory language.

Regarding the loan interest payments, the Department referred to 45 IAC 3.1-1-59 which states in relevant part:

> Interest income is nonbusiness income if the intangible with respect to which the interest was received did not arise out of or was not created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the intangible was not related to or incidental to such trade or business operations. The term "interest" as used in this regulation *[45 IAC 3.1-1-59]* includes service charges, time-price differentials, and all other charges for the use of money.
> …

The Department determined that the interest in question did arise out of the regular course of the taxpayer's business operations and was therefore business income and therefore should be included in the apportionment calculations.

Regarding taxpayer's argument that the regulation is invalid because it has not been updated since the enactment of IC 6-3-2-2.2, IC 6-3-2-2.2 does provide a new statutory-level method for how to determine if loan interest is attributable to Indiana which is not referred to by 45 IAC 3.1-1-59. However, the two are not discussing the same thing. IC 6-3-2-2.2 is designed to determine the attribution of business income while 45 IAC 3.1-1-59 is designed to determine if interest income is business or nonbusiness income, not where it should be attributed.

It appears that the loans are generally applied to the retail company. Therefore, a portion of the loans are applied to the retail company's Indiana operations. The Department apportioned the amount of interest applied to Indiana with the same formula as it used to apportion royalty income, as provided in IC 6-3-2-2(m), which states:

> In the case of two (2) or more organizations, trades or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

In this case, the loans are made by one business to another which is controlled directly or indirectly by the same interests. The Department apportioned the income from the interest payments with the same formula as it used to apportion the royalty income which fairly reflects the income derived from sources within the state of Indiana by the various taxpayers.

Additional support for the proposed assessments is found in the Department's treatment of companies that claim deductions for royalty income paid to related companies, such as the companies in the instant case. The Department has consistently determined that such a company cannot deduct such royalty payments, using virtually identical language and referring to the same statutes and regulations to reach those conclusions. Since this taxpayer is sufficiently close to the other companies to qualify as a consolidated group, the Department could have denied a deduction taken by the clothing companies for the royalty payments to the RRCs. This would have had the same effect on the consolidated group's income.

In conclusion, taxpayer availed itself of Indiana's markets by licensing its trademarks and tradebrands to an affiliated company doing business in Indiana. IC 6-3-2-2(a)(5) provides that this activity creates adjusted gross income derived from sources in Indiana and is therefore taxable here. The Department did not rely on a South Carolina case as its authority to tax the income. The regulations the Department did rely on are not invalid, even taking into account the 1990 revision to IC 6-3-2-2. The Due Process Clause and Commerce Clause of the Federal Constitution do not prevent Indiana from taxing the income. It can be determined that the proceeds of the loans are partially applied to Indiana, and IC 6-3-2-2.2(c) provides that the interest on those loans are partially applicable to Indiana. The Department properly included and apportioned the royalty and interest income.

FINDING

Taxpayer's protest is denied.

II. Tax Administration—Negligence Penalty

DISCUSSION

Taxpayer protests the imposition of a ten percent (10%) negligence penalty and interest, and states that the imposition of a negligence penalty is contrary to IC 6-8.1-10-2.1, which deals with the negligence penalty and its imposition. The Department refers to IC 6-8.1-10-1(e), which states, "Except as provided by IC 6-8.1-5-2(e)(2), the department may not waive the interest imposed under this section." Therefore, the Department may not waive interest.

Taxpayer states that the audit report states no factual basis for the imposition of penalties and that no factual basis exists. Taxpayer reiterates its position from Issue I that the proposed assessments are attributable to the treatment of the royalty-receiving company as subject to the adjusted gross income tax and includable in the consolidated returns, which taxpayer disagreed with. As explained in Issue I, the royalty-receiving company is subject to adjusted gross income tax and includable in the consolidated returns. At hearing, taxpayer was adamant that it had diligently attempted to comply with Indiana's tax methods and that it should not be subject to the negligence penalty.

IC 6-8.1-10-2.1(f) explains:

> The department shall adopt rules under IC 4-22-2 to prescribe the circumstances that constitute reasonable cause and negligence for purposes of this section.

The relevant regulation is 45 IAC 15-11-2(b), which states:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to reach and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

Also, 45 IAC 15-11-2(c) provides in pertinent part:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer has not affirmatively established that its failure to pay the full amount of tax due was due to reasonable cause and not due to negligence. In its protest in Issue I, taxpayer's arguments include relying on Financial Institutions Tax statutes to determine its actions regarding Adjusted Gross Income Tax, relying on an Indiana Tax court case which was not published until after the audit period, and relying on revenue rulings with materially different fact situations from its own. These are not reasonable causes to not pay the full amount of adjusted gross income tax due.

FINDING

Taxpayer's protest is denied.

WL/PE/MR 052701